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February 23, 2010

TY:

LEGEND:

Taxpayer (hereafter "Parent") =
Sub =
Region =

Dear

This responds to your request for a private letter ruling dated November 3, 2009, on whether gain from the exchange of certain emission credits may be deferred under § 1031 of the Internal Revenue Code.

FACTS

Parent is a headquartered in Region. Parent is also the common parent of a consolidated group. Sub is a wholly owned subsidiary of Parent and a member of Parent's consolidated group.

The concentration of ground level ozone (commonly known as smog) in Region often exceeds permissible air quality standards established by the Environmental Protection Agency (EPA). Ground-level ozone is principally created by two types of pollutants: nitrogen oxide ("NOx") and volatile organic compounds ("VOCs"). NOx is produced during combustion of natural gas. VOCs are organic chemical compounds that evaporate under specific conditions. Parent and its subsidiaries create NOx primarily during the process of and create VOCs primarily during the process of

The was created to develop and implement air pollution control measures in Region. In an effort to improve the Region's air quality and bring the area into compliance with state and federal law, the has

established a program to review and control emissions in Region. Under this program, businesses that take measures to reduce their emissions of pollutants, for example by installing emission reduction equipment, may apply for and receive emission reduction credits ("Credits"). Credits are used by the holder to "offset" emissions that would otherwise exceed permitted levels. Each Credit is a grant to the holder of the right to emit a specified amount of the pollutant per year for an indefinite period of time. Credits may be transferred temporarily or permanently.

Credits for the purpose of reducing ozone are designated by the _____ as either NOx Credits or VOCs Credits. Apart from the underlying pollutant, the terms and conditions of the two types of Credits are identical. NOx Credits may be used to offset VOCs emissions and VOCs Credits may be used to offset NOx emissions, as long as the holder of the Credits demonstrates that such use of the Credits will not cause or contribute to a violation of state or federal air quality standards.

Sub holds NOx Credits that were granted by the _____ when Sub installed air emission reduction equipment on its _____. Sub holds these Credits for productive use in a trade or business or for investment.

Parent anticipates the future need for VOCs Credits in order to meet emission standards related to _____. Although NOx reductions are far more desirable to the _____ than VOCs reductions in achieving the air quality objectives, the _____ has historically granted permission to use NOx Credits to offset VOCs emissions. However, this interpollutant use of the Credits is not economically optimal for Parent because the NOx Credits are more valuable due to their relative scarcity. From a business perspective Parent would prefer to exchange NOx Credits for VOCs Credits held by unrelated third parties. This would generally allow Parent to emit a greater amount of VOCs than if Parent obtains authorization by the _____ to use its NOx Credits to offset its VOCs emissions.

Sub possesses NOx Credits in excess of its needs. To satisfy Parent's need for VOCs Credits, Parent proposes to cause Sub to make a distribution of its NOx Credits to Parent. Thereafter, Parent proposes to exchange the NOx Credits it acquired from Sub for VOCs Credits held by unrelated third parties. Parent would then use the VOCs Credits to offset emissions from its trade or business.

Parent's basis in its Sub's stock exceeds the fair market value of the NOx Credits to be distributed by Sub to Parent.

LAW AND ANALYSIS

Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if

such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1.1031(a)-1(b) of the regulations provides, in part, that as used in § 1031(a), the words “like kind” have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not be exchanged for property of a different kind or class.

Under § 1.1031(a)-2(c), intangible personal property is of like kind to other intangible personal property only if (1) the nature or character of the rights involved are of like kind (e.g., a patent is of like kind to a patent and a copyright is of like kind to a copyright) and (2) the nature or character of the underlying property to which the intangible personal property relates is of like kind. For example, an exchange of a copyright on a novel for a copyright on a different novel is a like-kind exchange, but an exchange of a copyright on a novel for a copyright on a song is not.

Rev. Proc. 92-91, 1992-2 C.B. 503, section 3, Q&A 5, provides that emission allowances are treated as like-kind property for purposes of § 1031 of the Code. Therefore, an exchange of emission allowances that would otherwise result in the recognition of gain or loss under § 1001 is an exchange of like-kind property that qualifies for nonrecognition treatment under § 1031, provided the other requirements of § 1031 are satisfied.¹

Effectively, NOx Credits and VOCs Credits are government licenses or permits and constitute intangible personal property for federal income tax purposes. See § 197(d)(1)(D). Accordingly, the NOx Credits and VOCs Credits will be of like kind if the nature or character of the rights involved and the nature or character of the underlying property to which the intangible personal property relates are of like kind.

Both the NOx Credits and the VOCs Credits are rights granted by the _____ as part of its program to control air pollution in Region. The Credits are distributed by the _____ to businesses operating in Region, and enable the holder to emit a certain quantity of pollutant each year without penalty. The terms and conditions of the Credits are identical. Thus the nature and character of the rights involved are the same.

Although NOx and VOCs are different chemical compounds, they are both ozone-causing pollutants, and controlling ozone is the primary purpose of the Credits. As

¹ Rev. Proc. 92-91 provides guidance in a question and answer (Q&A) format on certain federal income tax consequences of the air emission allowance program (the “program”) established pursuant to Title IV of the Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2584 (1990), 42 U.S.C. section 7651 et seq. (the “Act”), with respect to utilities, non-utilities that elect to participate in the program, and other persons that acquire, hold, or transfer sulfur dioxide emission allowances.

such, the differences between the two chemical compounds, insofar as they relate to the Credits and the purposes for issuing the Credits, should be regarded as differences in grade or quality, not nature or character. As evidence that they are of the same nature or character, the rules make NOx and VOCs Credits interchangeable when certain conditions are met. Furthermore, both NOx and VOCs are emitted in the process of . That NOx Credits are more valuable than VOCs Credits because of their relative scarcity indicates a difference in grade or quality between the two types of Credits but not of their nature or character. Accordingly, the VOCs Credits and NOx Credits are of like kind.

CONCLUSIONS

1. Parent does not include the amount of the distribution of the NOx Credits received from Sub in its gross income. See §1.1502-13(f)(2)(ii). Parent shall reduce its basis in the stock of Sub by the amount of the distribution. See §1.1502-32(b)(2).

2. Sub's gain under §311(b) with respect to the excess of the fair market value of the NOx Credits over Sub's basis in the Credits shall not be taken into account upon the distribution of the NOx Credits to Parent or upon Parent's exchange of those Credits with a third party in an exchange qualifying under §1031(a). Sub shall take the gain under § 311(b) into account by reference to the VOCs Credits received in the §1031(a) exchange rather than the NOx Credits distributed to Parent. See §§ 1.1502-13(c) and 1.1502-13(j)(1).

3. The NOx Credits and VOCs Credits are like-kind property for purposes of § 1031(a) of the Code. Further, Parent is considered to have, prior to the exchange, held the NOx Credits for productive use in its trade or business. Thus, neither Parent nor Sub will recognize gain or loss as a result of Parent's exchange of NOx Credits for VOCs Credits immediately following the distribution of such NOx Credits from Sub, provided all other requirements for deferral under § 1031, not discussed herein, are satisfied.

CAVEATS:

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative(s).

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)

cc: